EQUALISATION RESERVES

For Insurance Companies' Non-Life Business

A Consultation Document

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Representations would be welcome on the matters discussed in this document.

They should be sent, by 29 October 1993, to:

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INTRODUCTION

1. The United Kingdom insurance industry has made representations for tax relief to be given on transfers into equalisation reserves for non-life, also commonly called "general", business. These representations have been made in the light of the emerging single European market in insurance, which will enable insurers to operate anywhere throughout the European Community under a single authorisation and regulation by their home state. Representatives of the industry have argued that insurance companies elsewhere in the EC will benefit from a tax advantage in competing in the single market, and in this regard point to their ability in some other member states to build up equalisation reserves free of tax.

2. The Government acknowledges that there may be a case for allowing tax relief on certain types of equalisation reserves covering occasional, exceptional losses. But for such reserves to be tax-deductible the Government believes that they would also have to be within the regulatory framework for the industry. This would be a major departure for both the tax and regulatory systems.

3. Announcing the issue of a consultation document on this subject, the Financial Secretary to the Treasury, Stephen Dorrell MP, said:

> "If there is a consensus that equalisation reserves for particular types of insurance business should become a regulatory requirement, and practical methods of isolating the business in question and of calculating the reserve can be found, we would need to consider carefully whether the introduction of a regulatory requirement, accompanied by tax relief, should be financed by compensating changes

> elsewhere. Given the overall fiscal position, I am clear that it would not be appropriate for the Exchequer to suffer a net cost from the introduction of such a scheme."

4. This consultation document sets out the issues that are relevant to whether insurers should be required to set up tax-deductible equalisation reserves, together with arguments in favour of the creation of such reserves for certain kinds of non-life business. It also looks at how the reserves could be calculated.

5. Representations on these matters would be welcome. They should be sent to:

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CHAPTER 1

THE UK NON-LIFE INSURANCE INDUSTRY

A varied industry

1.1 The UK non-life insurance industry is both large and varied. The DTI's 1991 Insurance Annual Report shows 634 companies to be authorised to carry on non-life business, of which 64 were composites (authorised for both long-term and non-life business) and 570 were authorised for non-life business only. Some insurance companies sell to clients directly or through agents and brokers, while others are reinsurers, who sell risk-sharing capacity to other insurers. In addition to a number of large companies which are household names, there are very many medium-sized and smaller ones. Many of the larger companies are composites, and many of the smaller ones are specialists in niche markets such as private health, financial risk or marine insurance. Forms of ownership vary - there are quoted public companies, subsidiaries of quoted companies, mutuals and privately owned companies. As well as UK-owned companies, there are also subsidiaries and branches of foreign companies both from within and outside the European Community.

1.2 Statistics published by the Association of British Insurers (ABI), a trade association for insurance companies authorised to transact business in the UK, show total net non-life premium income for 1991 amounting to just over £27 billion, of which some £17 billion related to risks located in the UK. These figures include some business written by non-members of the ABI and it is estimated that in total they cover about 93% of the worldwide general business premiums written by insurance companies authorised in the UK. Table 1 reproduces the breakdown by risk group and location of net non-life premium income worldwide. In 1991 the seven largest groups of companies each wrote non-life business worth in excess of £1 billion.

Table 1:

Net premium income world-wide 1991

	UK	Other EC countries	USA	Other overseas	Total (world-wide)
	£m	£m	£m	£m	**£m**
Fire and accident (non-motor)	10,229	1,346	1,699	3,127	**16,401**
Motor	5,209	1,164	1,272	1,434	**9,079**
Marine, aviation and transport	1,369	178	133	110	**1,790**
Total general business	16,807	2,688	3,104	4,671	**27,270**

Source: ABI Insurance Statistics 1987-1991

1.3 Lloyd's syndicates also conduct non-life business, but they are outside the scope of this consultation document as their commercial, regulatory and taxation structure differs from that of DTI-regulated companies. Within the corporate sector the wide variety of types and sizes of general business insurers means that the impact of any proposed regulatory and fiscal changes needs to be considered very carefully before they are taken forward.

An international business

1.4 Insurance is an international industry, and Table 1 shows that companies operating in the UK do a substantial amount of foreign business. The UK non-life industry can, in fact, be divided into three sectors. One sector services the domestic insurance market in the UK, both personal and corporate; another writes similar business in other countries through overseas establishments; and the London market provides reinsurance and specialised commercial cover, such as Marine, Aviation and Transport (MAT) and liability cover, on an international basis worldwide. The industry has traditionally been a major foreign exchange earner, and Table 2 shows that over recent years annual overall overseas earnings from insurance companies, including life insurers, have consistently been close to £2 billion. As much of the business traded by the international sector could be based in any one of a number of major cities, it is seen as important to UK national income and employment and to the balance of payments that those companies are encouraged to stay in London.

1.5 The non-life insurance industry serving the domestic market in the UK is also increasingly international in nature. In the last few years a number of UK companies have been bought by overseas companies, and a significant number of overseas companies have also set up subsidiaries in the UK. In 1970 the foreign-controlled insurers' share of the total UK non-life market (excluding Lloyd's) was estimated to be 14.0%, measured by premium income net of reinsurance premiums paid. By 1980 it had risen to 17.1%. In 1990, following a number of major acquisitions of UK companies by foreign groups, the share was 23.7% - and for MAT and reinsurance business, in which the international sector specialises, the figure was 45.7%. No statistical details are available of other EC insurers' penetration of the UK market, but it seems likely that this made up a significant proportion of the 23.7% foreign-controlled share in 1990.

Table 2:

Overseas earnings of UK insurance companies

	1987	**1988**	**1989**	**1990**	**1991 (projection)**
	£m	**£m**	**£m**	**£m**	**£m**
Underwriting (overseas business written in UK)	886	495	89	97	**-91**
Direct investment (profits from overseas business written outside the UK through subsidiaries, etc)	638	557	361	478	**490**
Portfolio investment (including life insurance companies)	802	799	1,072	1,224	**1,470**
Total*	2,326	1,851	1,522	1,799	1,869

*This does not allow for relatively small sums due to overseas parents.

Source: Central Statistical Office

1.6 UK insurers' net non-life premium income from other EC member states has also been rising, both in absolute terms and as a proportion of worldwide income. Table 3 gives the ABI statistics for this from 1987-1991. Over these five years their EC income went from £1.8 billion in 1987 to £2.7 billion in 1991.

Table 3:

Foreign non-life premium income of UK insurers

	1987 £m	1988 £m	1989 £m	1990 £m	1991 £m
Netherlands	510	513	565	528	536
Germany	335	303	383	403	476
Rep of Ireland	252	248	325	384	417
Italy	54	63	133	174	258
Belgium	223	215	255	258	198
France	202	199	239	224	182
Denmark	110	109	128	120	128
Other EC	134	158	303	368	465
EC Total	1820	1808	2332	2459	2660
EC % of global total	25.49	23.79	25.57	28.87	30.05
Global total	7138	7597	9120	8515	8849

Source: ABI Insurance Statistics 1987-1991

Challenges

1.7 The UK non-life industry faces a challenging environment in 1993. Many of the challenges are in areas that are far beyond the ability of the regulatory or fiscal regime to influence.

Restoring profitability and capital

1.8 The last few years have been very difficult for UK non-life insurers. The largest 10 companies have seen their combined premium income rise from £8.5 billion in 1987 to £11.6 billion in 1991, but this rise has been outstripped by that of claims incurred, which grew from £5.7 billion to £11.1 billion, a pattern that was reflected throughout most of the general business market. Each of the most recent years has set a new record for the cost to the insurance industry of a single insured event. The 1991 results for the industry after expenses and other deductions showed an overall trading loss of more than 12% of premiums written. 1992 results show improving profitability, or at least reduced losses, but not much internally generated strengthening of balance sheets.

1.9 Reasons for the losses include climatic, economic and legal developments. Dry weather in much of the UK has caused an increase in property damage claims due to subsidence. The hurricane in South East England in October 1987 cost £1.4 billion, but prior to that annual storm claims had been in the order of £200 to £400 million. And the historically high and heavy incidence of storms cost the industry £2.4 billion in 1990. A number of studies have shown a significant worldwide growth in major windstorm disasters, which some commentators speculate is linked to long-term environmental changes. The London market, as a world centre for reinsurance and for the placement of large risks, is particularly exposed to claims arising throughout the world and has been adversely affected by the large number of recent windstorms.

1.10 Many big industrial and commercial concerns are now choosing to retain a greater amount of risk in house, possibly through the use of captive insurance companies, and to restrict their purchase of insurance from the market to "top layer" cover for major claims only. The recession has also undoubtedly had an impact on insurers, particularly in the areas of pecuniary loss business, commercial fire and theft from property or vehicles. For some large companies, losses in mortgage indemnity business have been a major problem, and the ABI estimates that this cost companies well over £1.2 billion in 1991 alone.

1.11 Liability business has seen a rise in the number and size of claims. There have been increasing numbers of cases relating to pollution, industrial accidents and disease caused by exposure to substances such as asbestos. Courts, particularly those in the USA, have taken to making larger awards than they used to and to interpreting policy wordings to provide cover which insurers maintain was never intended. Many of these cases have taken years to emerge and be settled, and so relate to policies issued at premium rates which made insufficient allowance for these developments.

1.12 The industry has also suffered in recent years from the effects of the insurance pricing cycle. A period of profitability attracts new capital, which leads to increased competition for market share, and this in turn drives down rates and leads to losses. The losses eventually force some participants to withdraw from the market. This provides the opportunity for rates to harden again and brings renewed profitability for the survivors. This cycle can be seen in the important area of motor business, which is one of the largest and most competitive sectors of non-life insurance in the UK. Unfortunately there was a sharp rise in the cost of claims, due to theft and rising repair costs, at a time in the pricing cycle when rates were soft, which made the position much worse in 1990 and particularly in 1991 than would otherwise have been the case.

Changes in selling methods

1.13 Most insurance sold to the public has traditionally been channelled through brokers and agents. This way of doing business now faces increasing challenge from direct telephone sales of motor, household and some other personal lines. One estimate is that 10% of such business is now sold by direct selling methods. While this increased competition is not itself a problem, the upheaval in distribution methods could cause a return to soft rates and writing for market share of personal lines business.

Reinsurance capacity

1.14 Reinsurers have been badly hit by many of the same factors as have hit the profitability of the direct writers. The ease of entry to and exit from the international reinsurance market also produces sharp swings in underwriting capacity, causing at times large movements in premium rating levels. After a long period of excess capacity and a soft reinsurance market, the very large losses that have been incurred by reinsurers in the last two or three years, particularly on some types of liability business and on property catastrophe cover, have resulted in some substantial withdrawals from the market. Insurers are currently finding it far more difficult to obtain the amount of reinsurance protection they feel they need against very large losses and are having to pay considerably higher premiums. They are worrying more about the solvency of some reinsurers. There is also some increase in the use of financial reinsurance arrangements where there is little or no risk transfer, commonly with companies located outside UK regulatory and fiscal jurisdiction. These arrangements are often made in order to smooth their published results.

Threat of take-over

1.15 UK companies have felt that they are more vulnerable to take-over than their European counterparts, especially in the light of recent underwriting losses. It is easier to value UK companies than is the case in most EC member states, because UK accounting practices require more information on the market value of assets to be given in published accounts. In Germany, for example, the practice of accounting for assets at the lower of their cost or their lowest market price since acquisition makes valuation difficult. The Insurance Accounts Directive (1) will improve matters in this respect from the 1995 accounting year onwards, but because of its transitional provisions it will be several years after that before it is fully effective.

The opportunity of the single European market

1.16 The approach of a single European market in general insurance following the implementation of the Third Non-Life Directive (2) offers the opportunity of easier access to a large market. The UK non-life industry will be competing with large continental companies which have grown in more tightly regulated markets and which have historically done more business in Europe, while the UK industry has traditionally looked to the USA and the Commonwealth. However, in the new competitive market UK companies should benefit from their years of operating in a home market where policy conditions are not controlled

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(1) "Council Directive on the annual accounts and consolidated accounts of insurance undertakings (91/674/EEC)"

(2) "Third Council Directive on the co-ordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC, (92/49/EEC)"

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and be able to use their experience of such conditions to innovate and offer adapted types of cover to meet consumer needs in the single market.

1.17 The Third Non-Life Directive will extend the types of business that may be sold freely throughout the EC to include personal lines, such as household insurance, when it comes into force on 1 July 1994. It also provides that insurance companies will be able to operate anywhere within the EC under a single authorisation and regulation by their home state. But some differences in commercial practice are expected to remain between different member states. For example, continental Europe, with the exception of the Netherlands, has not traditionally used brokers but has tied agents instead, and this makes markets hard for newcomers to penetrate. Significant new opportunities will, however, soon be opening up and it is important that UK companies are in a position to take advantage of them.

1.18 The industry has, however, suggested that it may be handicapped by the lack of a level playing field for taxation in competing in the new single market. The matter of tax-free equalisation reserves in the single market was considered in the 12th Report of the House of Lords European Communities Committee, published in June 1991, which pointed in paragraph 23 to the question of the taxation of reserves as being a particular source of complaint by witnesses. It had been argued that the tax-free reserves of the German companies allowed them to take on new classes of business and to cope with catastrophes more easily, and that they gave the Germans an indirect pricing advantage by reducing the cost of capital. In its response to the Report, the Government said that it was prepared to consider timely action where it could be demonstrated that there was a significant fiscal impediment to the winning of new business opportunities in the emerging single market, but that such consideration would need to be balanced against its policy of levying tax on a broad base at a low rate, and the need to avoid unacceptable distortions in the tax system.

1.19 The advent of the single market is an appropriate time at which to consider aspects of insurance regulation and taxation more closely.

CHAPTER 2

THE REGULATORY AND FISCAL REGIME

Insurance regulation

2.1 The nature of the insurance industry is such that it differs in several material aspects from most others. For example, insurance companies, like banks and building societies, receive money from their customers at an early stage in the transaction in return for promises to fulfil certain obligations at later dates, some of which may be quite distant in time from the initial payment. It is usual for institutions operating in areas such as these to be subject to regulatory supervision in order to provide a measure of protection to members of the public who, through no fault of their own, could be very seriously disadvantaged if the institution turned out to be unable to discharge its obligations when they fell due. An institution such as an insurance company, which operates by selling promises to pay in the future, also needs to have the confidence of the public. If insurance companies are not seen to be in a healthy financial position, or to have enough capital to support the risks they are writing, the resulting decline in capacity and confidence would in turn severely affect the security of individuals and of other industries.

2.2 The UK insurance industry is in the main regulated by the Insurance Division of the Department of Trade and Industry. Insurance Division's supervision is based on statutory provisions derived from both UK and EC law, with the Insurance Companies Act 1982 and its accompanying Regulations forming the main statutory authority.

2.3 The fundamental aim of prudential supervision is the protection of the policyholder. The two main approaches of regulation are to monitor the solvency of insurers and to prevent persons who are not fit and proper from controlling or managing insurance companies. Insurance companies are required to prepare an annual return, a publicly available document which supplements their Companies Act accounts and assists the supervisors and other users in assessing their solvency position.

2.4 Each insurer carrying on business in the UK, including each pure reinsurer, has to maintain a minimum margin of solvency, which is a required excess of qualifying assets over liabilities. In practice, most non-life insurers maintain more than the minimum in order to ensure that liabilities to policyholders can be met in adverse circumstances. The required minimum margin for non-life businesses is calculated on a standard basis which was laid down in 1973 to apply throughout the European Community (to companies other than pure reinsurers) under the provisions of the First Non-Life Directive (3). There are two methods of calculation of the solvency margin, the premiums method and the claims method. The latter mainly applies to companies in run-off, or experiencing low premium growth and increasing claims ratios. There is also an absolute minimum known as the minimum guarantee fund.

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(3) "First Council Directive on the co-ordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance (73/239/EEC)"

2.5 Although the EC solvency margin has been harmonised, the approach to the valuation of insurers' assets and liabilities is less uniform, and will remain so until the implementation of the Insurance Accounts Directive brings some standardisation of approach to financial statements in 1995. For UK regulatory purposes the liabilities of an insurance company must be determined "in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies", and include "all contingent and prospective liabilities except liabilities in respect of share capital" (4). There is no formal accounting standard specifically relating to insurance companies but most of the larger insurers follow the Statement of Recommended Practice on Accounting for Insurance Business issued by the ABI and franked by the Accounting Standards Committee in 1990 (the ABI SORP).

2.6 Companies need to set aside funds in order to be able to meet their obligations to pay claims in the future. General business insurers need to provide for a number of different types of insurance liabilities, and these are reported under different categories on the DTI return. For business accounted for on a one year basis these include:

- known outstanding claims, which are ones which have been notified but not yet paid, and associated expenses,

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(4) Insurance Companies Regulations 1981, SI 1981 No 1654, Regulations 52 and 53

- incurred but not reported claims, which is where an event giving rise to a claim has already occurred but the company has not yet been informed. This delay in reporting may extend over many years, for example in connection with employers' liability for industrial disease when it may take a long time for the damage to manifest itself,

- unearned premiums, which are the relevant portion of the premiums which relate to policies in force at the accounting date and expiring after the year end. Events giving rise to claims may occur during the remainder of the contract period, and

- additional amounts for unexpired risks which are required when it is anticipated that the unearned premiums will be inadequate to meet the corresponding claims and expenses.

2.7 In some categories of business significant financial information does not become available until after the normal 12-month accounting period has ended, and companies are allowed to account for this business on a two or three year basis. This is generally described as accounting on a funded basis. Three year accounting is a regulatory requirement for non-proportional reinsurance (Accounting Class 9) and it is also generally used for MAT business (Accounting Classes 3, 4 and 5). For these classes of business, accounts are held open and profits are only recognised after the end of the two or three year period. If necessary, companies may keep a year of account open for a longer period, and after the account is closed at the end of the period companies have to maintain a fund that is sufficient to meet any expected future outgoings.

2.8 In view of the long period of time over which claims can emerge in certain types of business, for example liability, some companies choose to discount the value of incurred claims from their estimated ultimate settlement cost. The ABI SORP allows this on the basis that it recognises that provisions set aside now will earn an investment return over time, but the discounting must be explicit in the financial statements and based on satisfactory estimates of liabilities and a realistic discount rate. The regulatory view is that explicit discounting is acceptable providing a satisfactory estimate of the amount of the liability can be made and there is adequate past experience on which a reasonable model of the timing of the run-off of the liability can be constructed. The rate used should be conservative and disclosure must be made of the classes of business involved, the methods applied, including the discount rate used, and the effect on pre-tax profit or loss and the balance sheet for the accounting period. Its application and disclosure in the DTI returns must also be consistent with the general principle that liabilities must be calculated in accordance with accepted accounting practice. In implementing the Insurance Accounts Directive, the Government is proposing to exercise the member state option of permitting explicit discounting of provisions in certain specified circumstances.

2.9 All the components of the technical reserves have in common the fact that they relate to policies which were in force at the year end or in previous years. The ABI SORP also permits, but does not require, companies to designate separately in the balance sheet part of their funds as claims equalisation or catastrophe reserves. These would mainly relate to future business which has not yet been written. Equalisation reserves have been a regulatory requirement for one class of business, credit insurance, since the Credit Insurance Directive was implemented in the UK in 1990 (5). Given the losses incurred since then, few such reserves have, however, been built up so far. In the UK no tax relief is given on transfers made into equalisation reserves, and it is possibly because of this that equalisation reserves, which are common in some other countries, are infrequently found here.

Insurance taxation

2.10 The Tax Acts do not provide a discrete statutory code for the taxation of general insurance business, and the basic principles laid down in statute and developed in case law therefore apply equally to general insurance business and other trading activities. Only a few sections of the Income and Corporation Taxes Act 1988 specifically refer to general insurance and these do not amount to a distinct and separate set of rules for taxing it.

2.11 The basic principles which are important for insurance business include:

° the requirement to calculate for tax the annual profits or gains of the trade,

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(5) Insurance Companies (Credit Insurance) Regulations 1990, SI 1990 No 1181, implementing the "Council Directive amending, as regards credit insurance and suretyship insurance, First Directive 73/239/EEC on the co-ordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance (87/343/EEC)"

- the need to take due account of the ordinary principles of commercial accounting in quantifying those profits or gains, and

- the distinction between an expense incurred in earning the profits and an amount which is reserved or distributed out of those profits (for example, to cover future losses).

The starting point for a computation of the annual taxable profit of general insurance business is the profit as disclosed by the commercial accounts. This is then adjusted in conformity with generally applicable tax law.

2.12 However, while it is true to say that these principles hold good for the taxation of insurance business, the particular features of insurance mean that some problems are thrown up in a particularly acute form. This has led to the development of a number of facets of insurance company taxation that are either absent, or less important, in the affairs of other traders.

2.13 Probably the most significant of these concerns the provision for claims outstanding in the insurer's technical reserves. In computing the taxable profits of a business without the features of insurance a deduction for the cost of discharging a legal liability is normally only admissible in the accounting period in which the trader admits liability, or the fact of liability is determined by a Court. If this approach were applied indiscriminately to insurance business it would mean that no deduction for the expected cost of meeting a claim would be allowed until the fact of liability had been agreed or determined by litigation. Several years might elapse between the taxation of the premiums and the allowance of the cost of meeting the claims arising on the risks for which those premiums had secured cover. And, while in the interim there might be no certainty as to which of the claims outstanding would eventually be met, it is clear that on the balance of probabilities a high proportion of those claims will be met. Accordingly, it is accepted that a proper measure of profit can only be ascertained if a deduction for the future cost of meeting claims is allowed even though the insurer may not yet have admitted liability for paying any of those claims.

2.14 A deduction for claims outstanding is, however, only due where:

- without the inclusion of an amount in respect of the contingent obligation to meet those claims, the profits of the year will have been overstated, and
- a figure can be supplied which is reliable enough for the purpose of properly stating the profits.

2.15 The ABI SORP advocates that provision should be made at the end of the accounting period for the estimated ultimate cost of all incurred claims not settled at the accounting date. This provision should reflect the best estimate of the level at which claims will be settled. But, as noted in paragraph 2.8, the ABI SORP also permits explicit discounting of the provision in certain circumstances.

2.16 Where an insurer chooses not to discount its claims provisions, the Inland Revenue's understanding of the relevant case law is that, at least for so-called "long-tail business" (business where typically there is a delay of several years between the period of cover and the settlement of claims arising from that underwriting), only the present value of the estimated eventual cost of settling the claims can be allowed for tax. This view is by no means universally accepted by the industry and the accountancy profession.

2.17 The Inland Revenue also believes that, whether or not discounting is in issue, the deduction for claims outstanding must take as its starting point the best estimate of the ultimate liability. It is therefore not permissible to deduct an amount which has been added to that estimate by way of a safety margin in an attempt to ensure that the reserve is excessive more often than it is inadequate.

2.18 Some insurers include among their technical reserves an equalisation reserve for certain types of business and, as noted in paragraph 2.9 above, this is now a requirement for credit insurance. Because these are appropriations of profit to meet amounts charged to revenue in future years, mainly in respect of business not yet written, any sums transferred to the reserve are disallowed in their entirety under current tax law. Similarly, sums written back from the reserve to annual profits are disregarded in computing an insurer's tax liability.

2.19 For non-financial traders income arising from investments does not form part of trading profits but is instead the subject of separate assessment. Similarly, gains and losses on the disposal of such investments are dealt with according to the rules of Capital Gains Tax, though assessed to Corporation Tax in the case of incorporated businesses. However, the Courts have recognised that in the case of insurance business, in keeping with other financial trades, the income arising on the investment of policyholders' premiums and accumulated reserves is an integral part of the trading activity, and the Inland

Revenue has the right to tax much of this income as part of the trading profits. Profits and losses which arise when these investments are turned over are also regarded as trading items.

2.20 Some general insurance business is conducted on a mutual basis. The essence of mutual insurance is that, broadly speaking, the policyholders and the persons entitled to share in the profits of the company form a common class. A line of tax cases has established that where a company carries on business on a mutual basis any surplus arising from that trading activity is not taxable, and conversely a deficit cannot qualify for any form of loss relief. In such a case the Inland Revenue will normally assess the investment income under the appropriate head of charge and the gains on the disposal of assets under the Capital Gains Tax rules.

2.21 As noted earlier, some general insurance business is traditionally accounted for on a funded basis, and a balance of profit and loss is not struck at the end of the underwriting year but is only made after a further period of one or two years. For tax purposes the profit, or loss, whenever it is struck, is related back to the underwriting year and in the meantime the company will make a payment on account to the Inland Revenue of its estimated eventual tax liability for that year.

CHAPTER 3

EQUALISATION RESERVES IN EUROPE

A variety of approaches

3.1 In view of the approach of the single European market in insurance in July 1994, industry representations in favour of equalisation reserves have concentrated on the comparison with other European countries. It is therefore appropriate to look at what regulatory and taxation rules governing equalisation reserves there are elsewhere in Europe, and this Chapter considers various national provisions for them. It may, however, first be noted that such reserves are rare outside Europe, with Japanese catastrophe reserves for earthquakes and nuclear risks being an exception to this general rule.

3.2 Within Europe, not all countries have equalisation reserves as a feature of their regulatory or fiscal systems. Many, including the important insurance business centres of Switzerland, the United Kingdom and Italy, have no special supervisory or taxation regulations governing the setting up of equalisation reserves, except where the Credit Insurance Directive so requires. In these countries insurers may therefore set up equalisation reserves if they choose to do so, but they are not obliged to and no tax relief is given on sums transferred into the reserves. Elsewhere in Europe, a significant number of countries, including Germany, the Netherlands, France and Finland, do have special rules for equalisation reserves. These generally provide for tax relief to be given on transfers to the reserves, which must be calculated in accordance with set regulations. But there is no one European model for equalisation reserves, and notable differences exist between the rules in the various countries that have them. In particular, there are differences as to the classes of business that may or must be covered by the reserves, the maximum amounts that may be held in them, the methods of calculation, and the amounts of the annual transfers to or from the reserves.

3.3 Despite their differences, the various European models share one common function, which is to smooth the profits that emerge from the classes of business in question. The degree to which the profits and losses are smoothed is, however, not uniform and certain models favour transfers into the reserve above transfers out of it, so facilitating the build up of capital. All the models operate by setting sums aside out of the profits earned in good years to be drawn upon in later years when there is an underwriting loss or worse than average claims experience. This is the case whether, as in some countries, the equalisation reserves are designed to deal with all the classes of business that an insurer writes, or whether, as in others, they cater specifically for large, infrequent and unpredictable risks such as natural catastrophes and nuclear hazards. It is also true irrespective of the title or designation of the reserves - across Europe reserves carrying out this function can, for example, be variously called equalisation, catastrophe, deviation, contingency or safety reserves.

Regulation

3.4 Countries that provide for equalisation reserves do this with regulations that are almost always laid down by and applied by the insurance supervisory body. The regulations themselves vary in complexity from country to country and will, in general, include rules to stipulate the overall size of, or ceiling for, the reserve, the classes of business to be covered by it, and what any particular year's transfer into or out of the reserve should be. The tax treatment usually follows the regulations governing the calculation of the reserve, with transfers into the reserve being deductible in arriving at the insurer's taxable profits when they are made, and transfers out being taxable in the year that the sums are written back to profits. The reserves are, however, only tax free in so far as they are calculated in accordance with the relevant national regulations for equalisation reserves.

Types of business

3.5 Across Europe there is no uniformity as to the types of business for which various countries require equalisation reserves, although, as noted above, all EC member states must now have regulations governing the treatment of credit insurance. Credit insurance aside, countries with equalisation reserve regulations target the business concerned in one of three ways:

- by specifying certain defined classes of business,
- by specifying that the business in question must be sufficiently volatile (but leaving the final categorisation to be agreed between the insurer and the supervisory body), or
- by applying the equalisation reserve rules to all classes of business.

In Luxembourg there are separate rules for reinsurance which differ from those governing insurance business.

3.6 Where defined classes of business are specified, these will, in general, be the more volatile and unpredictable lines. For example, in France reserves can be set up for hail, natural hazard, space risk, nuclear, third party pollution and credit insurance only. In the main these are distinct classes of business for reporting purposes and so defining the scope of the reserve does not give rise to many problems in practice. In Germany, equalisation reserves are required for any "class" where there is a minimum amount of premium income and a minimum degree of volatility over time in the claims ratio (which is the relationship between the costs of settling claims and the earned premiums of a year), but the regulations do not stipulate named classes. Insurers can therefore agree with the supervisory body what constitutes a class of business for the purposes of setting up an equalisation reserve. The third option - that of applying equalisation reserve rules across the board to all business - would not appear to give rise to any initial difficulties in defining the practical scope of regulations, but it is possible, as in Sweden, for different reserving ceilings to apply to different classes of business. In Sweden these classes are as set out for statutory reporting purposes.

Calculating the reserve

3.7 Once the classes of business have been identified, the calculation of the equalisation reserve comprises three main factors:

- the preconditions, if any, which have to be met,
- the overall ceiling for the reserve, and
- the sum which has to be transferred into or out of it each year.

Some details of the various European models for these are considered in Annex I.

3.8 In general, it can be seen from a review of European equalisation reserves that existing models fall into two distinct types. One type looks primarily at statistical historic experience of the relationship between claims and earned premiums and bases the calculations upon standard deviations from the norm in the current year's experience. (Standard deviations are a measure of statistical variability.) This produces, on an actuarial basis, a transfer to the reserve where this claims experience is better than average, and a withdrawal of sums from the reserve in below average years. The German and Finnish models, for example, broadly work in this way, although both also make some additional provision for infrequent, catastrophic risks. In Germany this is done by requiring separate reserves to be set up for nuclear and pharmaceutical risks only. The other type of model for equalisation reserves, which includes the Dutch and French models as well as the German rules for nuclear and pharmaceutical reserves, works on a simpler basis by reference to the premium income and the profits of the year. Here sums set aside out of profits are drawn out of the reserve essentially to meet underwriting losses. Illustrative examples of how each type of model works are given in Annex II.

3.9 The overall ceiling for the reserve is usually related to the premium income of the class in question, whichever type of model is used. It is also dynamic in that in all countries it can go down as well as go up. But across Europe there is a large degree of variation in the levels of the ceiling, and some examples are given in Annex I. These reflect differences of national perception as to the optimum amounts to be held in the reserve, and perhaps also point to different functions for the reserve in the various countries concerned. Equalisation reserve models also commonly have different ceilings for different classes of business, with higher ones for the riskiest and most volatile lines. In Germany, for example, the maximum amount of the reserve for any particular class is arrived at by a formula that reflects the historical volatility of the claims ratio over a given period. And in France, as in Sweden and some other countries, a fixed percentage of the premium income for the class is used, with the set amount of the percentage reflecting the volatility of that line of business.

3.10 The method of calculating transfers into and out of the reserve depends upon whether the model is of an actuarial type, based upon standard deviations, or not. Where the model is not of the actuarial type, transfers into the reserve are made out of underwriting profits, whereas the actuarial models depend instead upon the incidence of better than average claims experience. Each type of model has a basic smoothing transfer which is calculated in one of these ways, and some examples of the different detailed rules are to be found in Annex I. In Germany and Finland a notional interest component is, however, also added to the reserve each year. This interest component exists whether or not the year's claims ratio has been better than average, so that under these models the reserve is likely to grow more quickly in the better years than it diminishes in the worse ones. When it comes to detailing the causes of a transfer out of the reserve and back to annual profits the various European models show a fair degree of uniformity. It is common for such a transfer to be required to meet an underwriting loss or worse than average claims experience, or where the reserve exceeds the permitted ceiling. And, in general, transfers into the reserve are tax deductible provided they are made in accordance with the regulations, and transfers out are taxed.

Solvency margins

3.11 There is also broadly uniform treatment of equalisation reserves in calculating insurers' statutory solvency margins for supervisory purposes. Nearly every European country treats them as technical reserves rather than as free reserves, which means that they form part of the insurance company's liabilities in determining whether it has met its solvency requirement. An exception to this rule appears to be Finland, where equalisation reserves can, if necessary, be treated as free reserves for solvency purposes, as used also to be the case in Spain. The current Spanish rules, however, now give tax relief for transfers to equalisation reserves, and treat them as technical reserves. There is therefore a general measure of agreement that equalisation reserves should not be viewed as free reserves for solvency margin purposes.

Overview

3.12 To sum up, equalisation reserves are clearly by no means universal throughout Europe, although a substantial number of countries do have them in one form or another. There is, however, no one set definition of an "equalisation reserve" and the models that are in existence in various countries range from covering, at one end of the spectrum, only predefined classes of volatile and unpredictable business to, at the other, all the business that an insurer writes. The method of calculating the reserve can be either by reference to profits and a multiple of premium income or by means of an actuarial calculation based on a number of standard deviations from average claims experience. There are also significant variations in the overall ceilings for the reserves and in the amounts of the annual transfers that are permitted to and from them.

3.13 Despite these important differences a number of common threads run through the various models that are in use in Europe. These are:

- all provide for some smoothing of profits by setting sums aside in better years to be drawn upon in worse years,
- all cater at least for large, volatile and unpredictable lines of business,
- all are governed by a body of regulation,
- all have ceilings that can go either up or down depending on current experience, and
- tax relief is in general given on transfers in (and transfers out are taxed) so long as the reserves are calculated in accordance with the set rules.

CHAPTER 4

WEIGHING THE ARGUMENTS

4.1 A wide range of arguments have been advanced to support the case for the creation of tax-allowable equalisation reserves. Many of these arguments concentrate on cyclical or market pressures on the insurance industry, which the Government does not believe constitute arguments for change.

4.2 It is argued, for example, that a number of changes are affecting insurance markets worldwide and that these are making the provision of satisfactory insurance cover more difficult. Advocates of this argument draw attention to:

- apparent climatic changes,
- statutory developments relating to the duty of care and liability to third parties for injury and damage,
- the tendency of Courts to award ever larger damages,
- the recent loss of reinsurance capacity,
- the relative growth of top layer insurance, and
- the growth in the size of individual risks.

Heavier costs arising from insurable events as a result of such changes must clearly be met by the insurance industry, and, ultimately, its customers. Except to the extent that some of the developments lead to greater volatility in insurers' claims experience (see paragraph 4.7 below) they are not good arguments for the creation of tax-free reserves.

4.3 It is also sometimes suggested that insurance companies should be able to create equalisation reserves to smooth the peaks and troughs of the economic cycle. The Government does not accept this argument. All types of commercial enterprises are exposed to the cycle. There is no reason why the tax system should uniquely allow insurance companies to smooth their profits in this way.

4.4 Equalisation reserves are sometimes seen as a way of providing insurers with extra long-term working capital. This would have the effect of smoothing their profits at a lower level than would otherwise have been the case, rather than simply equalising profits and losses over a period of time. Giving insurance companies a tax subsidy for this purpose would not accord with the Government's wider economic objectives.

4.5 Government policy over the last decade has been to levy tax at as low a rate as possible on a broad base, so eliminating as far as possible the need for special reliefs and avoiding distortions of commercial judgement caused by detailed provisions of the tax system. Any claim for a new tax relief must be evaluated in the light of this policy. Against this background the Government believes there are two telling arguments in favour of the creation of equalisation reserves.

4.6 First, the Government is alive to the fact that for a variety of reasons there has been a decline in the UK share of world insurance markets. It is often argued that this decline will accelerate as the single European market in insurance grows in importance, unless Government takes action to remedy disadvantages which are perceived to be created by UK tax rules.

4.7 Secondly, and more fundamentally, the Government can see the force of the argument that equalisation reserves could have a useful role to play in coping with the random incidence of very large losses in certain particularly volatile types of insurance business. The Government does not believe there is a strong case for tax-free equalisation reserves for all categories of non-life insurance, but it is willing to examine the implications of requiring, and giving tax relief on, equalisation reserves which enable insurance companies to spread volatile risks across more than one trading period.

4.8 The Government believes that this development would not only be defensible in principle, but would also respond to the insurance industry's concern about its competitiveness in the single European market. It is therefore further examined in Chapter 5.

4.9 It has been proposed that, if tax relief were to be introduced for equalisation reserves, the quantum of any tax-deductible transfer to an equalisation reserve should, subject to some industry guidelines, be a matter for individual negotiations between the insurer and the Inland Revenue. But if a reserve is required for prudential reasons, it follows that the DTI, as regulator of the industry, must play a part in deciding on the amount of that reserve. Such a suggestion would also be open to the criticism that it is inappropriate for individual companies to have the freedom to manage their tax liabilities in this way. In practice there would be a risk that the amount of any such reserve and the timing of transfers to and from it would be strongly influenced by considerations with little or nothing to do with the inherent merits of carrying the reserve.

4.10 Chapter 6 therefore considers the framework of rules which the Government believes would be necessary to govern the operation of an equalisation reserve system.

CHAPTER 5

THE CASE FOR REGULATORY AND FISCAL CHANGE

Volatile business

5.1 The last Chapter concluded that it would not be right to give tax relief across the board on equalisation reserves for all kinds of business. Nor does the Government think that it would be an appropriate burden on the industry to require equalisation reserves to be set up for general insurance business as a whole in order to provide extra capital or to counteract the normal effects of the economic cycle or the insurance pricing cycle. But the Government sees a case on prudential grounds for requiring equalisation reserves in addition to the protection offered by the solvency margin in order to cater for some especially volatile lines of business which are exposed to catastrophe risks. Compulsory reserves for such business would be in line with the supervisory requirements in a number of other countries, and, as noted in Chapter 3, those countries that give tax relief on sums transferred into equalisation reserves also require the transfers to be calculated in accordance with set rules.

5.2 Volatile claims experience is largely beyond companies' control, and the use of equalisation reserves to meet this problem is worth further consideration. Traditional techniques to control the fluctuations in profits and losses may be inadequate for types of business where there may be a random incidence of very large claims, either because insured losses occur so infrequently or because insufficient reinsurance cover is available at an appropriate price.

5.3 Volatile results, caused by claims falling appreciably more heavily on some years than on others, are a significant feature of certain types of general insurance business. One example is insurance against losses caused by major catastrophes, such as hurricanes and earthquakes, and companies selling insurance or reinsurance against this type of loss will expect a very different level of profits in years in which major catastrophes occur from that in years in which there are no such events. As noted in Chapter 1, the size and frequency of catastrophe claims have been extremely high since 1987.

5.4 One consequence of the recent high incidence of catastrophe claims has been a reduction in the amount of reinsurance capacity that is available, which in turn is likely to leave direct insurers exposed to greater volatility in their results and with an increased risk of failure. This development has been compounded by the growth in the size of claims. It may be that the consequence will be an increase in the volatility of general insurers' financial results. And while it is possible that natural catastrophes are now occurring more frequently, the increasing proportion of the insured population in high risk areas certainly means that many of today's events give rise to large claims on insurers where they would not have in the past. There is also a growing concentration of value in large man-made structures such as oil production platforms, so exposing insurers to bigger claims in the event of a major accident. The decision by many large industrial companies to restrict their purchase of insurance from the market to cover for major claims only is a further development that is affecting insurers' portfolios of risks.

5.5 If this analysis is correct, it is arguable that the traditional practice of regulating solvency by using a margin based on either premium income or a three-year moving average of claims may not provide an insurer with sufficient protection against the impact of such catastrophes.

5.6 Insurance is based on the principle of spreading risks over a large number of insureds, and, in relation to infrequent, catastrophic events, of spreading risks over time. The premiums charged by insurers normally assume that both of these spread techniques are possible. There is some conflict between the principle of spreading catastrophe risk over time and the conventional practice of having contracts of insurance that are renewable and re-negotiable on an annual basis. In practice, insurers often price contracts as if they were long-term in nature and include a catastrophe element which is calculated to spread risk over time. Following a major catastrophe, existing insurers may wish, or need, to rebuild their financial strength by increasing the catastrophe element in future premiums. But well-capitalised new entrants to a particular line of business, or existing insurers less affected by the catastrophe in question, may be able to afford to keep the loading to a lower level. On this analysis it can be argued that the annual accounting system does not cope particularly well with this kind of high risk/high reward business, because not all of the apparent annual profit is in reality true profit. Part of the apparent profit that is built into the premium needs to be set aside to help to finance the insurer's obligation to pay claims, when they arise, under subsequent renewals of the policy. A requirement for equalisation reserves for such business would help to ensure that insurance companies carry some reserves in advance for future catastrophes, and that new entrants begin to establish reserves from the outset, even if this depresses their initial profitability.

Disadvantages of current treatment

5.7 Under present accounting arrangements where equalisation reserves are little used, each financial year is regarded as an entity in its own right and a profit or loss is determined according to what has happened in that year alone. Accordingly, the earnings reported by general insurance companies tend to fluctuate from year to year rather more than is the case for the majority of industries. The adverse consequences which ultimately disadvantage the policyholder and the economy more widely include the following:

- investors value the shares of insurance companies less highly than those of other companies with similar overall levels of reported earnings emerging in a more even manner, with volatile earnings often described as "low quality". This tends to make it more expensive for general insurance companies to raise capital and can expose them to the risk of take-over at an unduly low price,

- in an attempt to counteract this, insurance companies are tempted to buy more reinsurance than necessary. To some extent, this merely transfers the situation to another company. Of itself, reinsurance is as valuable to the insurance industry as insurance is to the community as a whole. When, however, insurance companies are led to buy reinsurance which would otherwise be unnecessary solely to smooth their reported earnings, they are incurring unnecessary costs, which is unlikely to be in the interests of the economy as a whole.

Similarly, their capacity to write insurance is reduced because companies which buy unnecessary reinsurance for cosmetic reasons are not accepting as much risk as would be economically sensible,

- by way of an extension of genuine, even if unnecessary, reinsurance that is intended to circumvent insurers' inability to set up equalisation reserves out of untaxed profits, there is nowadays a considerable volume of what has come to be known as financial reinsurance. As mentioned in paragraph 1.14, little transfer of risk takes place under this and little economic purpose is served, but insurers make use of somewhat artificial transactions to exploit loopholes in the accounting conventions and so achieve specific changes in the presentation of balance sheets and revenue accounts. Financial reinsurance often involves the transfer of comparatively large sums of money out of the country to territories with a different tax regime and, in many cases, different standards of regulation. The company in question is usually weakened by making a contribution to the expenses and profits of a foreign-based company without obtaining a commensurate economic benefit in return. Moreover, a large portion of its assets is held off-shore by an organisation which is not subject to UK regulation and on terms which may severely restrict the company's access to its own assets. The lack of transparency makes regulation more difficult and can cause the regulator and other users of the company's accounts and DTI returns to misjudge completely its real financial state. It is also common for there to be at least a deferral of UK tax which would otherwise be paid, since investment income often accumulates free of tax or after tax at a very low rate in another jurisdiction, and

- after a period without major catastrophes, insurance companies can come to see the (often unidentified) catastrophe portion of their premiums as a profit loading with the result that it is eroded by competition, or distributed to shareholders when it should really be retained to fund claims payments when a catastrophe does occur.

A requirement for equalisation reserves

5.8 Against this background, the Government is considering whether or not it would be beneficial to recognise the essentially continuous nature of some types of non-life insurance by requiring United Kingdom general insurance companies to establish equalisation reserves in respect of those types of insurance. Under such a requirement, in years in which that business was profitable the company would have to calculate its annual profit or loss after deducting from it an amount which would go to an equalisation reserve, until the reserve reached an appropriate size. Conversely, if the company made a loss on that business, it would be obliged to transfer a sum from its equalisation reserve to offset the loss. As it would be prudentially unsound to take credit for profits yet to be earned, the equalisation reserve should never be negative and the amount drawn from it should not exceed the reserve at the time. Detailed consideration of how such a reserve should be calculated is in Chapter 6.

Regulatory consequences

5.9 In practice, the DTI does not rely solely on the coverage of the required minimum solvency margin when assessing the soundness of general insurance companies, but monitors a wide range of risk factors. The existence of a substantial equalisation reserve, if one were to be built up, would clearly give considerable comfort both to regulators and to policyholders, particularly where the insurer or reinsurer was engaged in those high risk types of business where the factors which influence the size of the required solvency margin do not adequately reflect an insurer's exposure. And where a company did not have a high level of free assets, an equalisation reserve which had been significantly reduced as a result of losses would be a clear signal that closer supervisory scrutiny would be required.

5.10 Equalisation reserves are intended to meet claims that are expected to occur but at a time that is unknown. Where set up in accordance with a regulatory requirement, they should therefore be considered a component of the insurance technical reserves (which are, in broad terms, provisions for obligations arising from insurance business). In this way they would be counted as forming part of the insurance company's liabilities when determining whether it had maintained its required solvency margin, treatment which is consistent with that already in force for credit insurance.

Taxation treatment

5.11 Insurance contracts giving rise to catastrophe claims are usually of short duration, and so on one analysis the present tax treatment of such contracts gives the correct result. The premiums of the year represent trading receipts and the cost of meeting claims is a trading expense. If claims under the contract are few and small in size, a significant trading profit may result which is properly assessed to tax.

5.12 However, this approach does not work well where there is premium loading for infrequent, large claims. This problem is already recognised and dealt with to some extent by the facility to set trading losses against the profits that arose from the same trade in an earlier accounting period, but for business generating claims of the kind described above the rules for carrying back tax losses may not provide a complete solution because the major underwriting losses occur too infrequently.

5.13 Accordingly, if equalisation reserves for this type of business were to become a regulatory requirement the Government is minded to accept that in principle amounts appropriated to the reserve should be treated as deductible in computing the trading profit for tax purposes. Amounts written back from the reserve would equally be treated as trading receipts. For mutual insurance business, where the surplus or deficit on trading activities is not recognised for tax purposes, appropriations to or from the reserve would therefore be tax neutral in effect.

CHAPTER 6

CALCULATING THE RESERVE

The design factors

6.1 This Chapter looks at the rules which would be needed if equalisation reserves for certain types of business are to be a regulatory requirement and eligible for tax relief. It considers, in turn, what rules there should be for:

- defining and identifying the volatile business in question,
- calculating the maximum size, or ceiling, for the reserve, and
- calculating the annual transfer into or out of the reserve.

It also discusses whether it is preferable to have one reserve for all an insurer's relevant business or a separate reserve for each category. In theory, the ideal ceiling for an equalisation reserve may be said to be the insurer's maximum probable exposure to losses from the relevant business over a year. And the ideal model would require the amount of any premium charged for risks subject to catastrophe losses to be transferred into the reserve, and the amount of any catastrophe losses to be transferred out of it. But, for a number of reasons, these ideals are unobtainable. This Chapter therefore considers a number of different design options for dealing with these questions, drawing on experience in other European countries for some of them. Comments would be welcome on the various options given here, or on other ways of calculating appropriate reserves.

Defining the business

6.2 As the Government does not believe that equalisation reserves should be required across the board for all categories of insurance, it is necessary first of all to target the particular types of business to which they should apply. There appear to be two main options for ways of doing this. First, as with credit insurance, named lines of business could be specified - for example nuclear, windstorm and earthquake risks. Alternatively, equalisation reserves could be required for any type of insurance where the insurer's own claims experience has proved sufficiently volatile over a given period. A statistical measure of volatility could be laid down by a formula along the lines of that used in Germany (and reproduced in paragraph 3 of Annex I). While specifying defined types of business has advantages of certainty and simplicity, an approach based upon companies' own claims experience might prove to be better tailored to insurers' individual portfolios of written risks. There may, however, be significant difficulties in taking such an approach, as a company's own past experience may have little relevance for its current portfolio.

6.3 A further question for consideration arises with policies that combine different types of insurance cover, where one element may be volatile and the others not. For example, the premium that is charged to the policyholder for householder's comprehensive insurance contains an element for the catastrophe risks, such as windstorm and earthquake, included in the overall cover. In this case, however, the major part of the premium is for the other risks against which the policy provides protection, and these are generally not of the sorts which give rise to volatility in claim amounts from year to year. The question to be addressed is whether, in such circumstances, it is appropriate to disaggregate the overall premium in order to isolate the part that relates specifically to catastrophe risks and to require an equalisation reserve in respect of those risks. Three solutions present themselves:

- disaggregation should be a regulatory requirement,
- there should be some discretion whether to set up reserves for disaggregated premiums, but if set up they should follow the normal rules, or
- there should be no disaggregation, on the basis that the provision of composite cover in itself gives sufficient spread of risk and reduces the volatility of the business.

6.4 Comments are invited on how the business relevant to equalisation reserves should be identified and isolated, and on whether this should entail the disaggregation of premiums.

The ceiling

6.5 For a reserve intended to cope with the random incidence of catastrophic events, it would seem reasonable to relate the maximum amount of the equalisation reserve to the catastrophe losses that might arise over a given period, say 12 months. But, in practical terms, there is likely to be considerable difficulty in quantifying what such an exposure actually is. It may therefore be necessary to relate the ceiling to something that can be more easily defined in numerical terms, and other European countries commonly link it to net premium income of the class concerned. This can be either by using a set percentage of premiums which depends upon the nature of the business in question, or by using a percentage derived from the standard deviations in the annual relationship between claims and earned premiums. In principle the ceiling for any given category of business should, in one way or the other, reflect the volatility of that business.

6.6 If premium income is used as the starting point for calculating the ceiling, this should be net of reinsurance. The calculation should also take into account the nature of the risks written by the insurer in return for the premium as, even within the same line of business, there can be significant variation in the relationship that the premium bears to the probable loss if the insured event does occur. For example, the premium for a certain level of insurance against damage caused by a hurricane which has historically occurred every five years on average will be different from the premium for the same level of insurance against damage from an earthquake which has historically occurred every hundred years on average. For these reasons, an equalisation reserve ceiling based upon premium income should be closely tailored to the portfolio of risks written by the insurance company if it is to meet the objective of being related to the amount of likely losses.

6.7 The simplest method of setting ceilings for different types of business is to use percentages, or multiples, of premium income, with the chosen percentage reflecting the average level of exposure for that business. This is the method used in France, where the relevant percentage for each class is set out in paragraph 4 of Annex I. Such ceilings would, however, produce a broad brush solution, and would not take account of variations between individual insurers' levels of exposure.

6.8 Relating the ceilings to the standard deviation in the ratio of claims to earned premiums for each category has theoretical attractions, but may give rise to practical difficulties. (The German rules, which follow this model, are reproduced in paragraph 4 of Annex I.) Fifteen years or longer claims experience may be needed to produce statistically reliable estimates, and even then the reference period would be too short to cope with those catastrophes that occur only once a century on average. A company which had not been writing relevant business over the length of the reference period would also have to rely on something other than its own experience, and suitable statistics might not be available. In any event, there may have been significant changes in social and economic conditions or in an insurer's portfolio over a fifteen year period, so limiting the relevance of earlier experience. However, such a model is used elsewhere in Europe, and it is for consideration whether it would be appropriate tc calculate ceilings in this way. The alternative of basing the ceiling only on recent claims experience or on current technical provisions appears unsuitable, as this would give rise to lower ceilings when there had been few recent catastrophes - and it is precisely then that transfers should be made into and not out of the equalisation reserve.

6.9 Comments are invited on how equalisation reserve ceilings should be calculated. Views would also be welcome on whether different ceilings should apply for different types of business, and on the appropriate levels for such ceilings.

Transfers in and out

6.10 Rules would be needed to define what amounts must be transferred into or out of the reserve in each year, and also what would cause such a transfer to take place. As has been seen in Chapter 3, existing European models appear to work either by reference to statistical variations in claims experience, or on the basis of premium income and profits or losses for the year.

6.11 For a reserve intended to cope with catastrophes it might seem that the amount of premium charged for catastrophes or for risks subject to catastrophes should be transferred to the equalisation reserve each year. Similarly, any amounts necessary to defray claim payments in respect of catastrophes could be transferred out each year. This would give rise to a theoretically pure equalisation of profit and loss. A number of models do, in fact, work by requiring a proportion of technical profits to be transferred into the reserve and requiring a transfer out of the reserve whenever there is an underwriting loss. It is for consideration whether such a rule - for example one requiring a transfer of 75% of underwriting profits into the reserve each year - would be appropriate. An illustrative example of such a rule is in Annex II. In practice the problems associated with disaggregating premiums and deciding in such cases what types of claims would count as being in respect of catastrophe risks would have to be addressed here, as in every other option where reserves are set up for named categories of business that do not coincide with reporting classes.

6.12 Alternatively, a transfer rule could be modelled on the German regulations and based on whether the claims experience of the year is better than average or worse than average. Sums would be transferred into the reserve in the better years and out of it in the worse ones. The German rules are explained in some more detail in paragraphs 5 and 6 of Annex I, and there is an illustrative example of such a standard deviation model in Annex II. This would entail keeping a run of historical data over a significant period, and so the same considerations as were mentioned in paragraph 6.8 above would apply in respect of the transfer rules. Analyses of the German equalisation reserve rules have, however, also shown that they would not have been suitable in their entirety for use in the United Kingdom in the recent past. This is because the comparatively greater importance of investment earnings in the UK and the rising rates of investment return during the medium term past have provided a cushion against the effects of worsening claims experience. The rising trend in claims ratios over this period would have meant that the requirement to make a transfer into the reserve would rarely have been triggered. Nonetheless, some elements of an approach based on statistical variations might be appropriate, particularly if falling UK interest rates lead to improved underwriting profitability.

6.13 One element of the German rules to be considered is the automatic transfer into the reserve each year of an interest component, calculated as a percentage of the reserve ceiling. This annual "interest transfer" within the ceiling predisposes the reserve to grow rather than diminish and enables it to build up more quickly. It may be desirable for any transfer rules to have such an inbuilt bias, whether achieved by these or by other means, to help the reserves to reach their optimum levels.

6.14 A third and different option for calculating transfers to and from the reserve is described in Annex II. This could work by looking at the "insurance profit" or "insurance loss" related to the catastrophe business in question - broadly speaking, the underwriting profit or loss plus a notional element in respect of investment earnings from that business. If the "insurance profit" exceeded, say, 5% of the relevant net premium income of the year then a proportion of the excess would be transferred into the reserve (95% in the example given). If there was an "insurance loss", an amount would be transferred out of the reserve. And there could also be an annual "interest transfer" into the reserve to represent the investment return earned in the year on the assets comprising the reserve (netted, as necessary, against any transfer out to meet an "insurance loss"). As with the other options outlined in Annex II, the figures given here are purely illustrative and do not represent a considered opinion on what actual values should be used.

6.15 It is envisaged that, whatever model is used for calculating transfers, the reserve should never exceed the ceiling. So, if the ceiling comes down to a level below the actual amount of the equalisation reserve, the excess should be transferred back to profits. Similarly, the reserve should never fall below zero and become negative.

6.16 Comments are invited on the methods for calculating required transfers into and out of the reserve. Views as to what would be the best method would be welcome, together, in particular, with whether it would be appropriate to include a notional interest component or other element to favour transfers into the reserve above transfers out of it. Comments are also invited on whether there should be overall limits on the size of annual transfers; how new entrants to a particular category of business or insurers ceasing to carry on relevant business should be treated; to what extent the calculation of underwriting profits or losses should make allowance for expenses; and what special features of funded business (see paragraph 2.7) need to be recognised in the calculation of transfers in and out.

One reserve or many

6.17 If there is to be a regulatory requirement for equalisation reserves, it must be decided whether there should be a number of separate reserves for different categories of insurance, or whether one reserve should cover the entirety of a company's business (with the exception of credit insurance). The former approach has the advantage of tailoring the regulatory burden and the tax relief to the types of business where current arrangements do not cater well for their special circumstances. Moreover, having separate reserves would link transfers to and from the reserve more closely to particular categories of business. It would, though, also require those different set categories to be individually defined.

6.18 On the other hand, it could be argued that separate reserves have the disadvantage that the reserve for one category might be exhausted so that nothing could be transferred out of it to meet losses, while there was still a positive balance in another reserve. In such circumstances a company might, for example, be unable to draw upon amounts in its nuclear risks equalisation reserve to meet losses arising on its windstorm business. Conversely, the same company might be unable to make a transfer from profits into the reserve for one category because it had already reached its ceiling, even though the reserve for another category might not be at its limit. If a company is required to set up reserves for certain types of volatile business, then it may be appropriate to allow it to draw upon all of them to meet losses arising on any category. This would point to the desirability of having one composite equalisation reserve.

6.19 Comments are invited on whether distinct reserves should be maintained in respect of each type of catastrophe risk, or whether one overall equalisation reserve should be set up for all such business. It might be possible to design a model that calculated the overall ceiling by aggregating individual maxima, but provided for transfers in and out on a unified basis, and views would be welcome on this.

Credit Insurance

6.20 The UK Regulations implementing the Credit Insurance Directive allow companies to calculate the reserve by using a choice from four methods. It is likely that, if equalisation reserves were also to be required for other lines of business, the treatment of credit insurance business would have to remain separate. However, one of the four existing methods of calculation would probably be regarded as the most appropriate and made compulsory. Comments are invited on which of the four methods should in such circumstances be chosen.

CHAPTER 7

SUMMARY AND ISSUES FOR COMMENT

Summary

7.1 For the reasons given in this document, the Government is considering making regulatory changes requiring insurance companies to set up equalisation reserves for certain types of particularly volatile non-life insurance business. If equalisation reserves become a requirement for such business, the Government is minded to allow transfers into the reserves to be treated as deductible for tax purposes in computing a company's trading profit or loss, and to tax transfers out of the reserves as trading receipts.

7.2 The Government believes that if equalisation reserves are to be set up for certain types of business, the requirement should be focused on high risk/high reward lines where the profitability of the underwriting is dependent on the random incidence of infrequently occurring events. The reserves should be classed as technical reserves for solvency purposes. It also believes that, in order to provide parity of treatment, they should be calculated according to a standard set of rules that will apply to all companies engaged in the relevant business. Only one method should, for this reason, be laid down for the calculation of the reserve.

7.3 The Government also wishes to tailor the amount of the equalisation reserve that it requires an insurer to hold to the portfolio of risks written by the company. In this way the reserve would best serve to provide the additional solvency protection that is thought desirable and to smooth the insurer's profits over time. The ceiling for the reserve should also have the potential to vary to reflect changes in the size and nature of the risks covered by the insurer.

Issues for comment

7.4 The Government would welcome comment on the desirability of equalisation reserves as a regulatory requirement for the types of non-life business discussed in Chapter 5. In particular, views are requested on:

- whether equalisation reserves should be required for certain volatile lines of business,
- if so, what those types of business should be, and
- what form the regulation should take for it to be effective and for the compliance cost to be acceptable.

7.5 Comment will also be welcome on how the equalisation reserves should be calculated, with particular regard to the following matters:

- how the business relevant to the reserve should be identified and isolated (see paragraph 6.4),
- whether the model should provide for the disaggregation of premiums (see paragraph 6.4),
- how the ceiling for the reserve should be calculated (see paragraph 6.9),
- whether there should be different levels of ceiling for different types of business (see paragraph 6.9),
- what level or levels would be appropriate for the ceilings (see paragraph 6.9),

- how transfers into or out of the reserve should be calculated (see paragraph 6.16),

- whether the transfer rules should include an element favouring transfers into the reserve above transfers out of it (see paragraph 6.16),

- what limits, if any, should be put on the size of annual transfers (see paragraph 6.16),

- what special rules, if any, should apply to new entrants to a particular type of business and to insurers who cease to carry on relevant business (see paragraph 6.16),

- to what extent the calculation of underwriting profits or losses should make allowance for expenses (see paragraph 6.16),

- what special features of funded business need to be recognised in the calculation of transfers into and out of the reserve (see paragraph 6.16),

- whether a company should be required to set up one overall equalisation reserve for all its relevant business, or a separate reserve for each category (see paragraph 6.19), and

- how credit insurance should be treated (see paragraph 6.20).

7.6 Representations are also invited on the suggestion that sums appropriated to equalisation reserves in accordance with set regulations should in principle be treated as deductible for tax purposes in computing a company's trading profit or loss for the year, and that sums written back from the reserves under those regulations should be treated as taxable trading receipts of the year.

ANNEX I

Details of European Equalisation Reserve Models

1. This Annex brings together some examples of the detailed European rules governing the calculation of equalisation reserves. It looks in turn at the preconditions that may have to be met for a reserve to be constituted, the overall ceilings for the reserve, and the annual transfer into or out of the reserve.

2. First, as is noted in paragraph 3.8, it can be seen that the various European models fall into two distinct types. One looks primarily at statistical historic experience of the relationship between claims and earned premiums and bases the calculations in an actuarial way upon standard deviations from the norm. The other is simpler and works by reference to the premium income and the underwriting profits or losses of the year. Although there is some overlap, the German and Finnish models are broadly of the former type, and the Dutch and French models of the latter.

Preconditions

3. In some countries there are preconditions for a reserve to be set up. These can, notably, relate to the degree of volatility required for a particular class of business, as the agreement of the supervisory body may be needed. Preconditions are unlikely to be needed, however, for practical reasons where equalisation reserves are either limited to specific classes only or extended to all classes of business. The German preconditions for general and accident business are as follows:

- average annual premiums in the current year and the two preceding years of business must exceed DM250,000,

- the standard deviation in the claims ratio (ie the relationship between the costs of settling claims and the earned premiums of a year) during the 15 preceding years must exceed 5% of the average claims ratio for that period (the period is extended to 30 years for hail and credit insurance), and

- there must be a pure underwriting loss in at least one of the 15 preceding years (30 years for hail and credit insurance).

Ceilings

There is wide variation in the levels of the overall ceilings that are permitted in different European countries. Where an actuarial model is used to calculate the equalisation reserve, the ceiling is generally linked to the standard deviation in the claims ratio. In the other models it is usually calculated as a percentage of premium income, with the standard percentage limit depending on the particular class of business. In Sweden the ceiling for certain classes also takes account of a percentage of net claims reserves for those classes. In all the models the ceiling can therefore come down as well as go up. Some examples illustrating the maximum reserves in various countries are:

Germany: 450% of the standard deviation in the claims ratio during the 15 preceding years multiplied by the earned premiums of the current year (600% of the standard deviation over the 30 preceding years for hail and credit insurance).

France: a percentage of premium income according to class -

200% - hail insurance

300% - natural hazards and space risks

500% - nuclear and third party pollution risk

134% - credit insurance.

Netherlands: 22.5% of premium income, with the exception that the ceiling is raised to 120% for insurers that write exclusively, or almost exclusively, storm or hail business. (Special provisions also apply to war-risk insurance.)

In some countries, such as Sweden and Luxembourg, there are also higher ceilings for reinsurance than is the case for insurance business.

Transfers in

5. The rules governing transfers into equalisation reserves also fall into two families. The simpler, non-actuarial method generally links the transfer to the profit made in the year upon which it is dependent. For example, in France the maximum annual transfer is 75% of the underwriting technical result for the class of business (defined as net premium income less claims, acquisition costs and a proportion of overheads). The annual transfer to the special German nuclear and pharmaceutical reserves is also limited to 75% of the underwriting

ANNEX II

Three examples of transfer rule models

1. This Annex gives illustrative examples of three types of model for calculating transfers into and out of equalisation reserves. Chapter 6 discussed whether these rules would be appropriate for catastrophe business written by UK insurers. In each case the figures chosen are used solely to demonstrate the mechanics of the calculation, rather than as a realistic portrayal of the underwriting results that may arise from such business. No detailed modelling has yet been carried out using data from catastrophe or other volatile types of business in order to determine what values would be the most suitable for inclusion in the various transfer formulae. There are also differences between the individual figures used to demonstrate each model, and so direct comparisons cannot be made between the bottom line transfers to or from the reserves in each case.

2. Within these constraints, the examples show the following methods of calculating transfers into and out of the reserves:

   A: a simple method based on the underwriting profit or loss of the period for the business in question,

   B: the German model, which uses statistical historic experience of the relationship between claims and earned premiums for the category of business and bases the transfer upon the deviation of the current year's experience from this. It also incorporates an "interest transfer" component calculated as a percentage of the reserve ceiling, C: a third method, which is based on "insurance profit or loss" - defined as the relevant underwriting result plus notional interest on the technical reserves. This also includes an "interest transfer" component, calculated as a percentage of the equalisation reserve at the start of the period.

3. Both methods A and B are to be found among the existing European models for equalisation reserves described in Chapter 3, and these examples serve to illustrate the difference referred to in paragraph 3.8 between the two main generic types of transfer rule. These are discussed again in Chapter 6 as options for transfer models for the UK, along with method C.

4. All the illustrations assume that the level of the reserve does not exceed the ceiling in any year. The figures given for "premiums" are for earned premiums and the figures for "claims" are for the incurred claims of each year. For the sake of simplicity, expenses are assumed to be nil. In each case, the examples are to be taken as relating only to the volatile business for which an equalisation reserve must be set up.

A: Underwriting profit or loss

5. This method appropriates a percentage of underwriting profits to the equalisation reserve in each year, and requires a transfer out of the reserve where an underwriting loss is made. In the example given the required transfers are 75% of underwriting profits and the whole amount of an underwriting loss. If required an additional element could be built into this model to favour transfers into the reserve, such as a notional interest component along the lines of these found in methods B and C.

B: Standard deviations - the German model

6. This example shows how a standard deviation method works in practice, using the German rules described in Chapter 3 and Annex I. It assumes that there is adequate statistical data, and notional figures are given for the average claims ratio over the historical reference period and the standard deviation in claims ratios over the same period. It also assumes that the preconditions for carrying a reserve outlined in Annex I are met in each year. The model shows both the calculation of the annual "interest transfer" as 3.5% of the ceiling for the reserve at the balance sheet date and the calculation of the claims shortfall or excess component. In the example both give rise to transfers into the reserve in the first and second years, but they are set against each other in the third year, resulting in a net transfer out of the reserve.

C: "Insurance profit or loss"

7. This third method, which was introduced in paragraph 6.14, is based on the "insurance profit or loss", defined as the underwriting result plus 5% of the average of the opening and closing technical reserves, excluding the equalisation reserves, of the accounting period. If the insurance profit exceeds 5% of the premium income of the year, 95% of the excess is transferred into the equalisation reserve. If the insurance profit is a positive figure but does not exceed 5% of the premium income, no transfer is made in respect of it. And if there is an insurance loss, a transfer is required out of the reserve in order to meet it. In addition, in the example given there is also an "interest transfer" component, defined as 5% of the opening equalisation reserve for the period. This is made irrespective of whether the insurance profit or loss calculation gives

rise to a transfer into the reserve, no transfer at all, or a transfer out of it.

8. The calculation can be expressed as the following formulae:

X = the underwriting profit (or loss) of the year + 2.5% of (the opening technical reserves, excluding equalisation reserves, + the closing technical reserves, excluding equalisation reserves)

Y = 5% of the premium income of the year

Z = 5% of the opening equalisation reserves of the year.

If X exceeds Y, the aggregate transfer to the reserve is: Z + 95% of (X - Y).

If X is positive, but does not exceed Y, the aggregate transfer to the reserve is: Z.

If X is negative, the aggregate transfer to the reserve is: X + Z.

9. Example C shows each of these possible outcomes in turn. In the first year transfers are made into the reserve in respect of both the insurance profit (X) and the notional "interest transfer" (Z). In the second, only the notional interest component gives rise to a transfer, into the reserve. And in the third, there is an insurance loss which is transferred out of the reserve and set against the notional interest component, resulting in a net transfer out of the reserve.

Example A: Underwriting profit or loss

	Year 1	Year 2	Year 3
Premiums	12,000	12,500	11,000
Claims	11,200	11,000	12,000
Underwriting Profit/(Loss)	800	1,500	(1,000)
Transfer to/ (from) reserve	75% x 800 = 600	75% x 1,500 = 1,125	(1,000)

Example B: Standard deviations - the German model

	Year 1	Year 2	Year 3
Premiums	9,000	10,000	11,000
Claims	8,500	8,000	13,000
Underwriting Profit/(Loss)	500	2,000	(2,000)
Claims ratio of the year	94.44%	80%	118.18%
Average claims ratio over reference period (say)	105%	103%	104%
Standard deviation in claims ratios over reference period (say)	10%	12%	11%
Reserve ceiling	450% x 10% x 9,000 = 4,050	450% x 12% x 10,000 = 5,400	450% x 11% x 11,000 = 5,445
Annual "interest transfer" component	3.5% x 4050 = 142	3.5% x 5400 = 189	3.5% x 5445 = 191
Claims shortfall/ (excess)			
Average claims ratio	105%	103%	104%
Claims ratio	94.44%	80%	118.18%
	10.56% x 9,000 = 950	23% x 10,000 = 2,300	(14.18%) x 11,000 = (1,560)
Aggregate transfer to/(from) reserve	142 + 950 = 1092	189 + 2300 = 2489	191 + (1560) = (1369)

Example C: "Insurance profit or loss"

	Year 1	Year 2	Year 3
Premiums	16,000	16,000	17,000
Claims	15,000	16,500	18,500
Underwriting Profit/(Loss)	1,000	(500)	(1,500)
Average of opening and closing technical reserves (say)	13,000	14,000	15,000
5% of average technical reserves	650	700	750
"Insurance Profit/ (Loss)"	1,000 + 650 = 1,650	(500) + 700 = 200	(1,500) + 750 = (750)
5% of premiums	5% x 16,000 = 800	5% x 16,000 = 800	-
Excess over 5% of premiums	1,650-800 = 850	200-800 = (600)	-
"Insurance Profit/ (Loss)" transfer	95% x 850 = 808	0	(750)
Opening equalisation reserve	1,000	1,858	1,951
"Interest transfer" component	5% x 1,000 = 50	5% x 1,858 = 93	5% x 1,951 = 98
Aggregate transfer to/(from) reserve	808 + 50 = 858	0 + 93 = 93	(750) + 98 = (652)